

# *The* **Estate Analyst**<sup>®</sup>

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## **Reincarnating the Estate Tax: H.R. 5638 and Beyond**

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The Permanent Estate Tax Relief Act of 2006 (H.R. 5638)<sup>1</sup> was introduced in the House on June 19, 2006, and was adopted three days later by a vote of 269 to 114. But this Act would not make repeal permanent.

The permanence H.R. 5638 contemplates would mean retaining an estate tax with a very large exemption. In fact, the new estate tax would be a very close reincarnation of the former estate tax.

Tax proposals tend to come and go by the dozen during every session of Congress, but there is good reason to believe that the basic compromise that may shape the next generation of estate planning may have now arrived at the table.

If nothing else, H.R. 5638 has become the starting point of discussion for any emergent compromise and, as we go to press, it is the only plan on the table.

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***Presented With Our Compliments***

How will the political endgame modify the final bill? Will Senate modifications force a conference committee process? How will the final tax law address the gift tax, state death tax credits, and the carryover basis?

Let's take a look at the proposals that are currently in play and place them in historical context.

### ***Recent History***

Congress intended to repeal the estate tax when it voted on the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) back in 2001. Congress had succeeded...but not completely.

By application of an arcane requirement, the Byrd Rule, a scenario resulted where no sooner would the repeal become effective in 2010...than it would be immediately followed by a return to an estate tax in 2011...as though it were 2001 again, but with a \$1-million estate tax exemption.

Neither a Star Gate nor a Time Lord of Gallifrey can dominate time travel along the tax law continuum as deftly as the United States Congress.

But perhaps the Byrd Rule was a moot issue. The duration of the phase-in period over so many years and so many economic cycles, not to mention political shifts, set the estate tax repeal up as a sitting duck for the relentless waves of tax reforms from Washington. Over the past five years, as the estate tax repeal began phasing in, Congress revisited the subject of making the repeal of the estate tax "permanent" more than once.

One such vote was scheduled to take place right after hurricane Katrina. The arrival of such large economic needs at that particular moment forced that vote to be abandoned. Most recently, on April 13, 2006, the House of Representatives passed a bill that would have made the estate tax repeal permanent. The vote was 272 to 162.

In contrast with the current compromise proposal, the compromise offered in April by Representative Earl Pomeroy (D-ND) which involved an immediate \$3-million estate tax exemption (\$3.5 million after 2009) was defeated by 194 to 238.

Remember, this was a legislative body that spent several years passing estate tax repeals that were vetoed and which had finally prevailed in 2001. These representatives also invested five years into the phase-in process and have seen ultimate victory within its grasp.

### ***A Context for Compromise***

Why has the House majority embraced compromise at this time? Will the Senate concur?

It is impossible to ignore the political context of the entire discussion, with predominant support for repeal coming from the current majority party. In a recently published report, former Republican House majority leader Dick Armey warned, "The Democrats will want to run on the 'do-nothing Congress' theme."

The current majority in Congress may see an estate tax compromise as the best way to secure an immediate accomplishment. Moreover, having repeatedly demonstrated the lack of sufficient votes to make the repeal permanent, and with the potential of losing some seats at the mid-term election decreasing the odds of ever securing enough votes, this current moment may have become the strategic time to secure the gains that were made, helping protect 99.67% of estates from being taxable. (Of course, 98% or 99% of those estates were already not subject to taxation, a fact that will go unnoticed in the hyperbole that culminates in the next "permanent" tax law.)

The larger context beyond politics is also less conducive to estate tax repeal. Public enthusiasm for the estate tax repeal may be waning. The United States had budget surpluses during that brief and euphoric time that launched the estate tax repeal. By comparison, we currently face budget deficits and large expenses ahead. It is a historical pattern, not a coincidence, that when revenues are short and it is every taxpayer for himself, people are more inclined to want to "soak the rich" with an estate tax.

### ***Repairing the Estate Tax***

Will Congress be able to pull back from the brink of the catastrophic confusion that would follow if the estate tax were repealed entirely in 2010 only to be reborn in 2011?

The potential for that undesirable path, and the last opportunity to change the tax proposal, have caused a wave of last-minute lobbying toward Congress. One such group is the venerated organization with 350,000 members of the accounting profession, the American Institute of Certified Public Accountants (AICPA), which wrote a letter to the Senate Finance Committee and its counterpart, the House Ways and Means Committee.

The June 22 letter encourages Congress to make the changes, whatever they are, well before the

current law expires after 2010. The letter then reiterates seven suggestions that the AICPA has been making for the past year or more.

1. Make permanent the generation-skipping transfer (GST) tax provisions that had been included in the EGTRRA package of 2001.
2. Increase the estate tax exemption and then index it for inflation so as to eliminate filing for 95% of estates from now on.
3. Retain the full step-up in basis to fair market value for inherited assets.
4. "Create a uniform exemption amount for estate, gift, and generation-skipping transfer tax purposes."
5. "Reinstate the full state estate tax credit, or provide another mechanism (such as a surtax) that would allow states to uniformly "piggyback" on the federal estate tax. To avoid diminishing tax revenues, many states have decoupled from the federal estate tax and enacted their own estate tax regimes, resulting in unnecessary complexity and uncertainty in both planning and administration."
6. Provide broad-based liquidity relief to all estates, rather than targeted relief provisions.
7. "Make the top estate tax rate no higher than the maximum individual income tax rate. We note that if the rate structure has a large gap between brackets, there may be significant uncertainty in the planning process for married couples with significant estates. For example, taxpayers may have to consider if estate tax should be paid at the death of the first spouse at a 15% rate compared to an alternative of paying the tax in the future but at a higher rate."

## *Meet the New Tax*

Here is how H.R. 5638 would resolve the basic transfer tax issues. As you can see, many of the changes will satisfy the AICPA's objectives. A notable exception is the state death tax credit, which was not included in H.R. 5638.

**THE ESTATE TAX:** The repeal is repealed. The estate tax is retained.

**TOP ESTATE TAX RATE:** Prior to EGTRRA, the top rate for estates over \$3 million was 50% but certain large estates were subject to a surtax of 5%, bringing the top effective rate to 55%.

**H.R. 5638:** Estates between \$5 million and \$25 million would be taxed at the same rate as capital gains. That amount is currently 15% and is scheduled

to rise to 20% in 2011. Estates above \$25 million would be taxed at twice the capital gains tax rate, i.e., 30% until 2011 and then 40% (i.e., twice the 20% rate).

*Note:* The proposed rates and exemption level would go into effect on January 1, 2010. That creates a sequence of top rates of 46% in 2006, 45% in 2007 through 2009, then instead of the tax repeal in 2010, the top rate would go to 15% for estates between \$5 million and \$25 million and 30% as the top rate for estates exceeding \$25 million. Then the top rate goes to 20% and/or 40% in 2011.

**ESTATE TAX EXEMPTION:** The proposed compromise retains the estate tax but provides a very high exemption of \$5 million. Also, a married couple would be able to carry over unused portions of the exemption, therefore allowing the couple to transfer \$10 million of assets without estate tax.

**FUTURE INDEXING FOR INFLATION:** For the first time, the exemption amount would be indexed for inflation after 2010. The exemption would be rounded to the nearest \$100,000. Note that the taxable bracket amount of \$25 million would not be indexed for inflation.

**HISTORICAL CONTEXT:** For the longest time, from 1987 through 1997, the estate tax credit of \$192,800 was the equivalent of an exemption of \$600,000. This number was initially generous, but without adjustment for inflation, fell behind the times. In 1997, Congress addressed this by gradually increasing the exemption. By 2001, the exemption level had reached \$675,000.

**INFLATION FACTOR:** Despite annual increases of \$25,000, the \$675,000 level of the estate tax exemption was still below what the exemption would have been with annual inflation. Estimates that adjust the exemption for inflation indicate that it would have reached \$750,000 by the late 1990s and \$1 million by around 2006.

The arrival of EGTRRA in 2001 accelerated the arrival of a \$1-million exemption from its originally scheduled arrival in 2006 to 2002. The \$1-million exemption remains waiting in the wings until 2011 when it will re-emerge if Congress fails to take corrective action in time.

**CURRENT EXEMPTION:** The repeal of the estate tax is currently being phased in. For 2006, the estate tax exemption is at \$2 million and would increase to \$3.5 million in 2009. In 2010, there would be no estate tax, and therefore no exemption. In 2011, the estate tax is reinstated at former tax rates and the estate tax exemption drops to \$1 million.

**PLANNING NOTES:** Spousal “portability” of the unified credit is one of the key innovations of H.R. 5638 that is an improvement over the previous law that is largely being reinstated. In essence, H.R. 5638 has codified the bypass trust, making this a universal benefit to all married couples. In fact, a spouse who remarries could potentially accumulate unused exemption amounts from several deceased partners.<sup>2</sup>

**ANALYSIS:** At the \$5-million level, the estate tax would be eliminated from all but .33 percent of all estates. This would be the lowest percentage of taxable estates at least as far back as 1934 when .88 percent of estates were taxable and the credit was the equivalent of an exemption of \$50,000.

The percentage of taxable estates climbed above 2% in the 1950s, surpassed 5% in the 1960s, and was at 7.65% in 1976. In recent years, with higher exemptions, the percentage of taxable estates fell, dropping below 2% for the 1980s and most of the 1990s, then climbing back above 2% in the late 1990s and early 2000s.<sup>3</sup>

For the most recent history of the past several years, about 1% of estates have been taxable. Dropping that to .33% exceeds the guidelines offered by the AICPA (see above), but it remains to be seen if that level will satisfy the members of the Senate who still are holding out for complete estate tax repeal.

**GIFT TAX & GST:** In 2001, the EGTRRA mapped out the parting of the ways for the gift tax from the estate tax and the generation-skipping transfer tax. H.R. 5638 re-unifies the transfer tax system in 2010, reassembling the taxes as they were prior to EGTRRA and causing the lifetime gift tax exclusion to jump from \$1 million to \$5 million at that time.

The annual gift tax exclusion, which has reached \$12,000, would continue to be indexed for inflation. Technical changes to the GST made by EGTRRA would remain in effect.

**CONSERVATION EASEMENTS:** Changes made by EGTRRA to conservation easements would also remain in effect under H.R. 5638.

**BASIS AT DEATH:** H.R. 5638 would retain the stepped-up basis for assets owned at death (other than income in respect of a decedent).

**STATE DEATH TAX CREDIT:** H.R. 5638 does not reinstate a federal credit for state death taxes. This is one key departure from the recommendations of the AICPA. In fact, H.R. 5638 repeals the deduction for state death taxes, making such taxes more painful to estates.

**CAPITAL GAINS FOR QUALIFIED TIMBER:** H.R. 5638 creates a new 60% deduction for qualified timber capital gains. This deduction, strategically added to the Bill to secure several key votes, would alleviate the disparate tax treatment of timber gains under current law (which is based upon the legal form of ownership of the timber assets). The provision is effective for qualifying gains recognized from the date of enactment through calendar year 2008.

### *The Senate's Decision*

How will the Senate modify HR 5638? Initially, members of the House rejected the idea of any changes necessitating a conference committee to work out any discrepancies between the House and Senate versions. But House leaders have since relented, since Senate members probably won't allow this opportunity to pass without getting their own fingerprints on the plan.

On July 10, 2006, Senate Majority Leader William Frist, M.D. (R-Tenn.) indicated that the Senate was looking for bipartisan support for a “permanent solution” to the estate tax but refused to commit to Senate action prior to the August recess. However, the House's version had, at that point, had not convinced the existing Senate factions to come together in unity. In both June and July, 2006, the Senate was three votes short of the 60 required to break a filibuster and put the repeal of the estate tax to a vote. However, political pragmatism may yet lead to consensus in time for the next election.

Naturally, there are revenue considerations to every decision. Immediate repeal of the estate and gift tax in 2001 would have cost up to \$662 billion (over 10 years). The Joint Committee on Taxation estimates that H.R. 5638, as it now stands, would cost \$283 billion between 2007 and 2016.

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## **TECHNICAL REFERENCES**

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1. For information on H.R. 5638 as passed by the House, see Joint Committee on Taxation, Technical Explanation of H.R. 5638, The "Permanent Estate Tax Relief Act of 2006" as introduced in the House on June 19, 2006 (JCX-20-06), June 20, 2006.
2. Analyst Jeffrey Pennell notes that under the proposed law, “serial monogamy” could result in the accumulation of unused exemptions. See, Steve Leimberg's Estate Planning Newsletter # 982 (June 20, 2006).
3. General historical background on estate tax exemption levels can be found in two recent articles by the Congressional Research Service by Nonna A. Noto (June 29, 2006) and Jane G. Gravelle (June 23, 2006)(economic impact of transfer taxes), both available on [Tax Analysts](#).